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May 20, 2014

Mr. Barry F. Mardock  
Deputy Director  
Office of Regulatory Policy  
Farm Credit Administration  
1501 Farm Credit Drive  
McLean, VA 22102-5090

RE: Proposed Rule on Standards of Conduct – RIN 3052–AC44 / *Federal Register* 79  
(February 20, 2014) 9649-9661

Dear Mr. Mardock:

Frontier Farm Credit, ACA (Frontier) appreciates the opportunity to provide comments on the Farm Credit Administration's (FCA) proposed rule regarding standards of conduct. We believe that high standards of conduct and ethical business practices are fundamental to the way Frontier and other Farm Credit System institutions conduct business and fulfill our mission of service to agriculture and rural communities. We certainly understand and share the FCA's desire to ensure that System institutions continue to live up to their current high ethical standards. We are, however, deeply concerned that the Agency's proposed rule in this area is fundamentally flawed and should be significantly revised and re-proposed for public comment.

Our concerns are detailed below and have been developed in close coordination with CoBank, the Farm Credit Council, and other FCS associations. While the comments below are Frontier's alone, we believe the principles on which they are based are shared by our affiliated associations. The FCA undoubtedly will receive individual comments from many associations as well as individual directors from Frontier and other associations. We urge the FCA to carefully consider all of these comments. In addition, we strongly support the comments submitted by the Farm Credit Council as they reflect the consensus views of the entire Farm Credit System on this important matter.

### **Overall Comments**

Frontier finds many provisions of the proposed rule to be needlessly burdensome, unworkable in many respects, and incompatible with the cooperative structure of Farm Credit institutions. We encourage the FCA to rewrite the proposal in a more pragmatic fashion and re-propose it for further public comment.

Most importantly, the treatment of directors, especially the pre-approval requirement for transactions between directors and customers, is a serious disincentive for qualified individuals who wish to serve as directors and therefore undermines the cooperative governance structure established by Congress for the Farm Credit System. Strong, qualified directors are critical to the success of a cooperative, including Farm Credit System institutions. The proposed rule's requirements would in many cases be so burdensome – with no corresponding benefit to safety and soundness or mitigation of conflicts of interest – that many directors or potential director candidates simply would choose not to serve.

We also are concerned that the proposed rule, in its current form, shifts the burden for compliance from individual directors or employees on to the institution via the standard of conduct official. Many of the proposed rule's provisions appear to anoint the standards of conduct official as an all-knowing enforcement official. Under the proposal, the standards of conduct official, most likely supported by a team of employees necessary to handle the daily administrative burden, would have to investigate the backgrounds of all individuals on a continuous basis in order to reasonably ensure compliance with the proposed requirements by individuals (see proposed §612.2160(a)).

In many cases, the standards of conduct official would be required to make scores of daily determinations on routine matters as directors nearly continuously seek pre-approval of normal course of business transactions. This proposed regulatory standard is impossible to meet and entirely unnecessary. It is far beyond the standards applied to other regulated financial institutions and even the government itself.

Fundamentally, an institution can only be responsible for administering its standards of conduct programs and addressing ethical violations in an effective manner. It is unreasonable to hold an institution accountable for regulatory, ethical and conduct violations of the individuals they employ. The proposed rule effectively sets up institutions and the standards of conduct officials for failure and requires institutions to establish burdensome standards of conduct programs that will weigh negatively on the corporate culture given it creates a "police state" atmosphere based on regulations that require rigid and repressive controls. We see this very real result as contrary to what is occurring today under existing regulations. Today, the standards of conduct official is a resource who works in tandem with employees, directors, and agents for the betterment of the institution and the System through the effective management of conflicts of interest and assistance in compliance with regulatory requirements.

We are troubled by the unworkable subtle shift in the proposed rule from individuals being accountable for their conduct under the regulations to institutions being accountable. The approach is ill conceived and it is out of step with well-established industry best practices, where directors and employees are responsible for making disclosures, and the standards of conduct official helps manage identified potential conflicts of interest. If a director or employee fails to make appropriate disclosures or engages in a conflict matter, the standards of conduct official then completes an investigation and takes appropriate action. FCA's proposal moves away from this highly effective business practice and places the standards of conduct official in an untenable position of being responsible and accountable for the quality and accuracy of individual's disclosures. This is entirely inappropriate and establishes an ethics environment of a "catch me if you can" set of incentives where the standards of conduct official is placed in an impossible position and makes ethical conduct a negative issue.

In addition, the FCA's proposal vastly overreaches in its treatment of "agents" of System institutions. FCA's proposed standard goes well beyond that of any other financial regulator and would be a strong disincentive for any firm or person that could be construed as an "agent" from working on behalf of a System institution. Compliance with the proposed rule in this area would be virtually impossible in today's marketplace.

We ask the FCA to fundamentally revise the proposed rule to make it workable for System institutions. We believe that this can be accomplished while still achieving a strengthening in requirements in an appropriate manner.

## Section-by-Section Comments

### §612.2130 Definitions

The proposed rule provides a definition for the term "**agent**". We find this definition to be overly vague both as it relates to individuals and entities that represent a System institution in contacts with third parties and to providers of other professional services similar to legal, accounting and appraisal services. We find that "agent", under this definition, could potentially include individuals and entities such as underwriters of preferred stock, ratings agencies, administrative agents in syndicated loan transactions, providers of information technology services, contract employees provided by temporary employment agencies, or consultants, among others. It is unclear from the definition who FCA intends to capture by the requirements concerning agents. We recommend that the definition be clarified and examples be included of the types of individuals and entities that do or do not constitute "agents".

The proposed rule's definition of "**controlled entity**" or "**entity controlled by**" sets a five percent ownership or voting control threshold that is very low for the term "control". While we recognize the proposed rule represents no change to this definition, we do not believe that five percent truly signifies "control" in an entity. We believe that a higher threshold would more suitably reflect FCA's intent and also suggest that the term be changed to "disclosable interest," while the definition remain the same due to the importance of this concept for standards of conduct. This change is needed to avoid confusion with terms "controlled entity" or "entity controlled by" as used elsewhere in the regulation or commonly for other purposes, such as for attribution or financial reporting purposes.

The definition of "**employee**" is needlessly complex. For the purposes of this regulation, we ask that temporary employees with an intended tenure of less than six-months be excluded from the definition. The required training programs and disclosure processes for any employee with an expected tenure of less than six months, such as an intern, would be needlessly burdensome and expensive. We suggest that defining "employee" as "any officer or part-time or full-time employee" removes ambiguity resulting from the use of "salaried" or "non-salaried" in the definition. The FCA should also clarify if this definition covers contract employees.

The newly inserted language in the definition of "**family**" ("anyone whose association or relationship with the director or employee is the equivalent to the foregoing") is open-ended and should be removed. If this added language is attempting to be inclusive of domestic partnerships, common-law spouses, adopted children, or other relationships, we believe that those should be explicitly included in the definition. Alternatively, other sections of the proposed rule refer to "any relative or person residing in the director's (or employee's) household." We find that "anyone whose association or relationship...is the equivalent of the foregoing" would have already been captured by this requirement and therefore makes the newly inserted language duplicative and unnecessary.

The proposed rule's definition of "**material**" is overly vague and is open to various interpretations by examiners. We urge FCA to provide latitude to institutions to define "material" in a manner appropriate for their individual institution and marketplace. Examiners could then review performance against an established standard.

### §612.2135 Responsibilities and Conduct

The proposed rule runs contrary to the Administrative Procedures Act by inappropriately awarding "policy statements, instructions, procedures, and guidance" the same weight and authority as formally promulgated regulations. Additionally, the use of "guidance" in this section

is ambiguous and makes full compliance with this section impossible. It is unclear how a System institution is to know if "guidance" includes statements made by FCA examiners during closeout discussions, informal emails from FCA staff, etc. Institutions should not be expected to speculate as to whether something is considered guidance by FCA's definition and FCA should not establish requirements that effectively circumvent clear administrative standards relating to regulatory and supervisory practice. This is massive regulatory overreach and appears to be an effort by the Agency to provide itself with the ongoing ability to redefine – without any formal rulemaking – any standard or requirement in the regulation. It is entirely inappropriate and should be removed from the final rule.

### **§612.2136 Conflicts of Interest**

We certainly agree with FCA that material conflicts of interest should be reported on a timely basis by all System directors, employees, agents, consultants, etc. We strongly disagree, however, with the implication of the Agency's proposed rule that transactions entered into in the normal course of business all cause conflicts or potential conflicts of interest. The example provided in the preamble to the proposed rule cites the purchase of a combine harvester from a known borrower. We strongly contend that no conflict of interest exists in this transaction and no reporting requirement should be triggered.

Since System institutions are cooperatives, System directors are elected from among System customers. As a result, it is only natural and appropriate that System directors have ongoing business with other System customers. They buy seed, sell services, purchase equipment and enter into innumerable other routine business transactions nearly every day. None of these pose a conflict of interest to the director's decision-making ability and as a result, none need be disclosed.

Perhaps most importantly, FCA's proposal ignores the fact that the vast majority of System boards of directors no longer participate in the loan approval process, further lessening the chances for conflict of interest. The FCA already has specific provisions that prohibit System directors from using their position to gain any unfair advantage on a transaction. Further reporting in this regard serves no purpose.

Similarly, many System employees own and/or operate farming operations requiring them to, on a routine basis, enter into transactions with customers. Depending on their position in the System institution, they might not have actual knowledge that they are dealing with a customer. In some instances, System employees are partial owners and do not actually operate their farming enterprise and the operator, often a spouse, has no way to know who is or is not a customer of the institution. The FCA's reporting requirement in these situations is impossible to comply with and serves no real purpose related to conflict of interest.

Unreasonable disclosure requirements are a severe disincentive to serving on System boards of directors. As directors of Farm Credit institutions are required to be farmers, ranchers, producers or harvesters of aquatic products (with the exception of outside directors), they need the flexibility to manage their operations without having the standards of conduct official inserted into day-to-day transactions. We are especially concerned with any implication that FCA rules would require an ongoing prior-approval process whereby the standards of conduct official would have to review and approve routine transactions entered into by directors in the normal course of business.

We urge the FCA to consider the following standard for requiring disclosure:

- No prior approval (or post-transaction approval) is needed from the standards of conduct official for ordinary course of business transactions between borrowers and directors or employees involving the purchase or sale of goods, services or other real or personal property.
- With regard to the purchase or sale of goods, services or other personal property in the ordinary course of business, a director or employee will be required to report to the standards of conduct official on a post-transaction basis if the director or employee had actual knowledge that the other party to the transaction was a borrower, but if and only if:
  - a. In the case of a director, the institution's board had not previously delegated to management authority to approve and collect loans; or
  - b. In the case of an employee, the employee's job duties include loan approval or loan collection.
- In our experience, real estate property transactions do not occur as frequently as do transactions involving the purchase or sale of goods, services or other personal property, making it less burdensome to require reporting of these transactions in all cases where a director or employee actually knows that the other party to the transaction is a borrower. Therefore, with regard to real estate property purchase transactions, we recommend that the regulation be revised to provide that a director or employee will be required to report a transaction involving the purchase or sale of real estate property with a borrower to the standards of conduct official on a post-transaction basis provided the director or employee had actual knowledge that the other party to the transaction was a borrower.

In addition to our broader concern, we find that the extension of this section to "consultants who provide expert or professional services to the System institution" to be problematic. The addition of "consultants" compounds the already existing confusion around the definition of "agent" discussed in the definition section of the proposed rule. It is unclear to us who, in addition to agents, FCA is attempting to capture by the inclusion of "consultants". We ask that this language be stricken from the proposed rule in order to provide additional clarity.

#### **§612.2140 Director Reporting & §612.2150 Employee Reporting**

The proposed rule requires directors and employees to report to the standards of conduct official "the name of any relative or any person residing in the director's (or employee's) household, any business partner, or any entity controlled by the director (or employee) or such persons (alone or in concert) if the director (or employee) knows or has reason to know that such individual or entity transacts business with the institution or any institution supervised by the director's (or employee's) institution." We do not agree with the FCA's presumption that a Frontier director or employee would know or have reason to know whether or not a relative or other persons residing in the director's or employee's household had or has transactions with our association. We doubt that a Frontier director or employee would necessarily know about each and every transaction that a relative might have with the association. Further, whether or not a director or employee would "have reason to know" about such transactions creates additional confusion and ambiguity. Either a director or employee does, or does not, know about any given transaction between any of the listed individuals or entities and a Farm Credit institution. Those transactions that are in fact known by the employee or director should be sufficient for the reporting standards. For these reasons, we ask that FCA apply an "actual knowledge" standard to this requirement prior to issuing the final rule.

#### **§612.2145 Directors – Prohibited Conduct & §612.2155 Employees – Prohibited Conduct**

As currently written, the proposed rule requires the standards of conduct official to make written determinations on a case-by-case basis in order for a director or employee to enter into any financial transaction with another director, employee, agent, borrower, or loan applicant of their institution. We find it completely unnecessary for a director (or an employee who might have a part-time farming operation) to be required to request documentation from the standards of conduct official prior to making a routine purchase from a local feed store or selling a commodity to their co-op. It is the reality of the small farming communities in which our directors and employees live and work that commerce goes on between employees, directors, and member-borrowers. This requirement has the potential to place the standards of conduct official in the middle of dozens of ordinary course of business transactions on a daily basis and further shifts the standards of conduct official's role to that of an enforcement official. It is unrealistic to think that directors or employees, many of whom run successful operations, have the time necessary to comply with such a burdensome requirement. We ask that the FCA consider including a provision in this section exempting transactions which occur "in the ordinary course of business" from this pre-approval requirement.

The proposed rule currently requires that these determinations made by the standards of conduct official be renewed annually. We find this requirement to be unnecessarily burdensome. Once a determination is made by the standards of conduct official, it should only be required to be renewed or updated as the circumstances around the determination change as disclosed by the director. If nothing has changed, then the annual review is simply a bureaucratic process with no substantive value and all of the associated costs.

Further, the preamble of the proposed rule makes clear that the standards of conduct official cannot ratify prohibited conduct after the fact and that the director or employee would be considered to have violated the regulation should they enter into a transaction without prior written approval. As currently written, this does not provide a director or employee incentive to disclose such a transaction which occurred in the past and may have been inadvertently overlooked. Moreover, it creates an untenable situation where disciplinary action would be immediately required despite the circumstances and intent, which fundamentally create a negative "caught you" ethics environment. In order to strengthen the rule and encourage transparency, the standards of conduct official must have the authority to ratify transactions which have occurred in the past as they deem appropriate.

FCA's recent regulation on unincorporated business entities (UBEs) acknowledges that many System institutions hold and manage foreclosed collateral indirectly through acquired property UBEs. We ask that FCA update the prohibitions on property owned or acquired through foreclosure or similar action to include property acquired by a System institution indirectly through an acquired property UBE. This update is necessary to make the standards of conduct regulation consistent with the UBE regulation.

#### **§612.2160 Institution Responsibilities**

Paragraph (a) of this section requires that each institution must "ensure compliance" with this part. We find it unrealistic to assume that an institution can truly and accurately "ensure" that individuals will comply with any regulation from a practical standpoint. It is appropriate for an institution to take all necessary steps to ensure compliance including, but not limited to, requiring education on policies to their constituencies and mandating signatures acknowledging such policies. However, because an institution cannot fully guarantee compliance by individuals, we find it inappropriate for the regulation to require an institution to "ensure" compliance, therefore holding the institution responsible for the actions of individuals. We ask

that FCA consider revising this paragraph to reflect that an institution cannot truly "ensure" compliance with a regulation, but that it can take all necessary steps to effectively ensure that it maintains an effective standards of conduct program that supports compliance by individuals. This approach ensures that accountability for regulatory compliance is appropriately maintained between the institution and the individual, with the institution accountable for maintaining the program and the individual accountable for their own conduct with respect to the program and regulatory requirements.

In paragraph (a)(3), the regulation states that Farm Credit institutions are required to notify FCA immediately of known or suspected material standards of conduct violations. We find the term "suspected" to be overly ambiguous and having the potential of being interpreted differently by various parties. Any number of misunderstandings or misinterpretations could easily be considered a "suspected" violation, but the reporting of such suspected activities without proper research and proof appears dangerous on several levels. For these reasons, we ask that FCA remove the phrase "or suspected" prior to issuing a final rule. We also ask that the requirement to notify FCA "immediately" be changed to "promptly" to be consistent with the language found in Section 612.2170(b)(7) of the current regulations. Moreover, the FCA should set materiality standard for reporting so as to avoid reporting on inconsequential issues, such as delayed updating of a disclosure form. Such a materiality standard will decrease the level of burden to institutions as well as to the FCA while maintaining the intent of the disclosure process.

Further, we have concerns that this provision, as currently drafted, would have negative implications regarding attorney-client privilege. For example, the disclosure of privileged information to a third party, such as FCA in this case, could be deemed as a waiver of the attorney-client privilege between the institution and its legal counsel. It is inappropriate to require an institution to waive such a privilege. We believe that the regulation should be adjusted to clarify that only non-privileged information is required to be reported to FCA in these circumstances.

Frontier has serious concerns regarding the requirement that third party agents who are not subject to industry or professional ethics standards must certify adherence to the bank's Code of Ethics. In our research, we do not find this requirement to be market standard for either publicly-traded companies regulated by the Securities and Exchange Commission (SEC) or other financial services institutions regulated by federal banking regulators. As a mission-based lender, Frontier makes it a priority to contract the most qualified agents available. We are concerned that this requirement could have the unintended consequence of limiting the number of third party agents willing to work with Farm Credit institutions. As the agent realizes no benefit in agreeing to such certification while at the same time possibly exposing themselves to legal liability as a result, we believe most third party agents would be unwilling to work with FCS institutions. This would diminish the pool of qualified service providers and quality of available services and, in turn, increase risk and cost for the Farm Credit System. We feel strongly that this provision is overreaching, burdensome, and serves no real purpose. FCA should revise the provision to permit customary business practices with agents that address conflict, conduct, and confidentiality within contractual agreements. Importantly, there is well established case law within this area, which is not the situation of FCA regulatory standards of conduct requirements.

We strongly urge the FCA to remove this third-party agent requirement, rely on a contractual conflict provision and provide a robust grandfather provision for existing contracts and agents, which in total would be workable and provide the strong framework for agent ethical conduct. The FCA should not impose unique or non-uniform requirements for conflict provisions in agent contracts that are inconsistent with well-established legal standards to applicable contracts.

The time and resources required to get all existing contracts updated with the added requirement around a Code of Ethics certification would be insurmountable. Importantly, our suggestion of a grandfather provision in no way supersedes our basic belief that the application of this requirement for agents is unreasonable and counterproductive to FCS safety and soundness. The requirement should be removed prior to finalizing the rule.

Further, given the numerous implications in the standards of conduct regulations for agents, we ask that FCA consider revising the final rule so that the provisions pertaining to agents are consolidated in a single section. We find that it would be unduly burdensome for agents to be expected to review the standards of conduct regulations in their entirety in order to identify the applicable provisions.

#### **§612.2165 Code of Ethics, Policies, and Procedures**

The proposed rule requires the board to "establish criteria for business relationships and transactions not specifically prohibited by this part". We find this language to be overly vague and potentially applicable to any type of business transaction or relationship which could conceivably take place. We find it unrealistic to expect a Farm Credit institution to come up with criteria for each and every business relationship or transaction which could potentially transpire. We ask that FCA remove this requirement prior to issuance of a final rule or, alternatively, clarify its intent.

Paragraph (b)(2)(i) of this section assigns the standards of conduct official the responsibility to review all loans under Sections 614.4460 and 614.4470 for compliance. In many cases, the standards of conduct official may not be the most appropriate person in an institution for such an undertaking. There could conceivably be many instances where the standards of conduct official is not someone with the technical expertise or knowledge of terms, interest rates, or other relevant information necessary for such a role. It would be appropriate for the standards of conduct official to have the authority to delegate this responsibility to a designated loan committee or another individual whose role is more aptly suited for such a responsibility. We ask that FCA make this delegation authority clear prior to issuing a final rule.

We appreciate that individual institution's boards of directors are granted the authority to consider case-by-case exceptions to conflicts of interest requirements. We find this authority to be appropriate and reflective of good governance principles. We do note, however, that paragraph (f) of this section grants FCA the right to find that "a particular financial interest or transaction, relationship or activity constitutes a conflict of interest or an appearance of a conflict of interest", therefore making the exception process essentially useless. We ask that FCA consider providing some context around the circumstances around which FCA would exercise this authority to override an institution's determination. We believe this would assist boards of directors as they develop their own policies and avoid potentially arbitrary and inconsistent interpretations by examiners.

Finally, we find the entire section overly prescriptive. It is not necessary to enumerate in such specificity all of the various policy issues that must be addressed. The result is a proposed rule that will be inflexible and quickly become irrelevant as well as obsolete. We ask the FCA reduce the prescriptive and excessive detailed requirements of this provision.

#### **§612.2170 Standards of Conduct Official**

The proposed rule requires the standards of conduct official to report a "known or suspected criminal or standards of conduct violation by a director, employee or agent [which] may have an adverse impact on continued public confidence in the System or any of its institutions". While



we have already addressed our concerns with the term "suspected", we also recommend that FCA drop the phrase "adverse impact on continued public confidence in the System or any of its institutions". This phrase is essentially undefinable in any meaningful way. System directors and employees are well aware of the importance of reputational risk facing System institutions, however, the proposed rule appear to inappropriately assign ownership of reputational risk to the standards of conduct official. Instead, it is the duty of all directors and employees to closely guard the reputation of their institution.

#### **§612.2180 Standards of Conduct for Agents**

This section states that an agent "may not knowingly acquire, directly or indirectly, except through inheritance, any interest in real or personal property, including a mineral interest, that was owned by the employing institution or any supervised or supervising institution as a result of foreclosure or similar action during the agent's employment" for one year after the transfer of the property or after termination of the agency relationship. It is important that the restriction specifies that it only applies to the transactions in which the agent directly participated in the deliberations or decision to foreclose or take similar action. As written, this restriction is far too broad and it would be impossible for a standards of conduct official (or an agent) to know whether the association or its supervising bank had any prior ownership interest in a particular property. We feel that the restriction of this requirement to those transactions in which the agent was directly involved would maintain the intent without becoming overly burdensome and unrealistic.

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Thank you again for allowing Frontier Farm Credit the opportunity to comment on this important regulation regarding standards of conduct. We hope that these comments have provided FCA with some perspective on how the proposed rule will affect the System from a practical standpoint. As previously noted, we find this topic to be of the utmost importance and look forward to working with FCA to ensure a workable final rule. Please contact me if you wish to discuss our comments or require additional information in support of our comments.

Sincerely,

A handwritten signature in cursive script that reads "Douglas D. Hofbauer". The signature is written in dark ink and is positioned above the printed name and title.

Doug Hofbauer  
Chief Executive Officer